March 27, 1968

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The address of MR. OSCAR RECHTSHAFFEN, President, to the Annual Meeting of the shareholders of FEDERAL SAVINGS AND LOAN CORPORATION, to be held on Friday, March 29, 1968 at 11 a.m. in the Saskatchewan Room of the Royal York Hotel, Toronto.

THE GREAT BANK ROBBERY

I have entitled this address "The Great Bank Robbery" because I feel that it is a caption which, although facetious, immediately focuses attention on the main theme of my comments.

The Government of Canada made some cardinal mistakes in the amendments to the Bank Act which came into force on May 1, 1967. Observing the profound and widespread effects of these errors in the eleven months since then, in my opinion, it has resulted in:

(1) reduced instead of increased competition which threatens the very existence of loan and trust corporations,

(2) higher mortgage rates and shortage of mortgage funds for new housing,

(3) has been a major contributor to domestic inflation,

(4) has hindered the development of secondary manufacturing industry in Canada.

(1) THE MISTAKES OF THE GOVERNMENT IN THE BANK ACT AMENDMENTS RESULTED IN REDUCED INSTEAD OF INCREASED COMPETITION

In 1964, the Porter Royal Commission on Banking and Finance recommended "that the Bank Act be extended to cover a wider group of institutions which are now engaged in the business of banking.....and that a broader range of lending powers be granted to all banking institutions. Thus, in addition to leading to removal of the 6% ceiling and mortgage prohibition

applying to the present chartered banks, our recommendations would permit the savings banks and the trust, loan and other companies coming under the banking leglislation to compete for commercial and personal lending business." (Page 563)

Their intention was clearly to increase true competition. The only way that can be done is by increasing the number of competitors, with equal legal powers to compete. Otherwise, freeing the banks to pay and charge any rate they pleased, by removing the interest ceiling, merely gave the banks a sword with which to destroy their disadvantaged competitors, whose powers remained unchanged.

It was intended to extend the powers of both banks and loan and trust corporations, so that they would be identical. However, the amendments to the Bank Act, extended the powers of the banks only. The Government completely ignored the balancing recommendations of the Porter Commission, in spite of the Commission's warning of the dangers of such action leading to reduced competition through excessive concentration of power in the banks.

(2) RESULTED IN HIGHER MORTGAGE RATES, SHORTAGE OF MORTGAGE MONEY FOR NEW HOUSING AND THREAT TO THE EXISTENCE OF LOAN AND TRUST CORPORATIONS

Prior to the amendment of the Bank Act, the banks paid 3% on savings deposits and the major loan and trust corporations paid 4%. The banks pleaded that the removal of the ceiling on bank loan rates was necessary so they could pay competitive rates on savings deposits, and restore the banks to a more equal position with their competitors in bidding for funds. They also said that removing the ceiling on loan rates would lower the cost of borrowing for the average small businessman.

The chartered banks had the advantage of size, thousands of branches, and commercial, personal and mortgage loan facilities in their favour. They needed only to raise their rate on savings accounts to 4% to equal their competitors, and still grow faster. However, on May 1, 1967 they immediately overbid their competitors by raising their rate to 4 1/2%. On March 1st, 1968 the banks increased this rate to 5%. In both cases the loan and trust

corporations were obliged to increase their rates to match the banks, or lose their deposits. So the rates were the same, but the effect on earnings for the two types of institution was vastly different.

The largest category of bank assets were demand loans, on which they immediately raised the rate of interest, increasing the cost of loans in Canada, while increasing their profit margin under the new rate structure. The loan and trust corporations' main assets were long-term mortgages, on which the interest rate could not be changed, and the profit margin on their existing mortgage investments declined as interest rates rose.

The effect of this squeeze raised new mortgage rates to historical highs. It caused lenders to divert funds which otherwise would have been loaned for new housing into liquid short term investments, at a time when the need for mortgage funds for new housing is critical.

New mortgage rates would not have to be as high, if existing debtors' rates could be raised, instead of, in effect, being forced to penalize new borrowers to subsidize existing low-yielding loans to previous borrowers, in order to maintain a reasonable <u>average</u> margin of profit on a portfolio.

The cost of funds over a period of years would be more equitably shared by all borrowers, old and new, and the sharp peaks in interest rates which develop periodically could be reduced.

This desirable result would be achieved <u>by broadening the powers</u> of loan and trust corporations <u>to include the ability to make demand loans and personal loans</u>, giving them a wider range of types of investment, as the banks have, with an ability to vary the portfolio average yield from time to time.

In the United States there are some 17,000 banking institutions including commercial banks, savings banks, savings and loan associations and trust companies. The rate of interest commercial banks may pay on savings deposits is 4% by law. Time deposit certificates are exempt from this regulation. In late 1966, American commercial banks seeking deposits to meet

strong loan demand, evaded the 4% regulation. The banks lowered the minimum amounts of certificates of deposit to as low as $1,000 which made them, for practical purposes, ordinary deposits. They raised the interest paid on them to such high levels that they threatened to destroy the liquidity of the other banking institutions, which had fixed-yield mortgages as their main assets. These thousands of other institutions protested these tactics to the Government. They warned it would cut off mortgage funds for new housing, and was resulting in a crisis of liquidity. The Government acted promptly to limit the rate of interest the commercial banks could pay on certificates of deposit, to restore sanity to the rate competition between these two classes of institutions.

A parallel situation exists in Canada today. One reason a united outcry from the loan and trust corporations is not heard in Canada, is that many of the largest loan and trust companies have banks as major shareholders. It could hardly be expected that the professional management of these corporations would publicly criticize the tactics of their influential shareholders. Immediate action by the Government is necessary to rectify this situation.

(3) INFLATIONARY EFFECTS OF THE BANK ACT AMENDMENTS

Many prominent Canadians have recently decried settlements, granting wage increases of up to 16% over one or two years, as inflationary. Inflation is robbing Canadians they warned. Inflation threatened economic disaster.

Compare what the banks have done recently to interest rates. Between May 1, 1967 and March 1, 1968 they raised the rate paid on savings deposits from 3% to 5%, an increase of 66 2/3%. They raised the cost of loans to the average businessman over 40% in these eleven months from 6% to 8 1/2%. Interest on personal loans rose to 12%. This is the purest form of wilful inflation.

At this time there is no economic justification for a 66 2/3% increase in the rate of interest paid on savings deposits. These deposits are purely domestic funds, not sensitive to the influence of international interest

rates. They are liquid savings of the average Canadian, about $700 per person. Monetary policy, bond yields and money market rates are immaterial, as these average savings deposits do not particpate significantly in those markets.

The banks may justify the increase by saying savers should earn more. They say savers should not be obliged to subsidize borrowers by unrealistically low loan rates which the banks said in the past forced them to pay low savings rates. I agree, but please note that the increase on savings was 2%, but the increase on loans was 2 1/2%. The banks in their enthusiasm to assist the savers, did not forget to increase their own margin of profit also by 25% of the increase.

The fallacy in their argument is that the average Canadian gains pennies, but loses dollars. The majority of Canadians under age 65 are net debtors, not net creditors, when their liquid savings are compared with their debts. They earn more on their small savings, but pay more on their much larger debts.

Also, since business generally operates with borrowed money, the increased cost of business loans is ultimately reflected in the cost of all goods and services used by all Canadians. Net personal saving is less than 10% of disposable income. Therefore, the average Canadian earns a little more on 10% of his disposable income, but pays more for all goods and services when spending the remaining 90% of his income. It is obvious that the harm from high interest on both savings and loans is over nine times as great as the benefits.

This analysis makes it a little easier to understand at least one aspect of the puzzling form of inflation we now have, and to pin-point one specific source. Classical inflation occurs when the demand for goods and services exceeds the productive capacity of a country to provide them. We have excess capacity now in Canada in almost every industry, yet we have inflation nevertheless. This is cost-push inflation. The domestic savings deposit interest rates are a major contributor to current inflation, because of the

widespread influence of bank rates on all business, and the vast amounts of money deposited in the banks.

(4) HINDERED THE DEVELOPMENT OF SECONDARY INDUSTRY IN CANADA

The benefits of true competition among financial institutions can only be achieved by increasing the number of competitors on equal footings. Such competition is necessary for the development of Canadian secondary industry. We complain that foreign ownership of Canadian industry is excessive, and that we lack a sufficient degree of secondary manufacturing.

A contributing factor to this problem is the Canadian banking system. The Government fostered a banking system consisting essentially of eight chartered banks, the five largest with thousands of local branches. The United States has encouraged the opposite system of thousands of local and regional "Unit" banks with relatively few branches. The rise of that country to the world's leading free enterprise economy eloquently recommends the merit of their system. The fact that the United States has a number of small bank failures each year is trivial. The savings of the public are protected against loss by deposit insurance. The benefits to the small businessman and the growth of secondary industry are enormous by comparison.

The small businessman in almost any community in the United States may approach one or more of his local banks. He will likely be dealing with its head office. The loan officer he speaks to will likely be a higher-level executive with greater decision-making authority than the average branch manager of a Canadian bank. He is free to go from bank to bank in his area or elsewhere, until he finds one that perhaps wants his business more than the others. Or until he finds a particular loan officer who has more experience or insight into his specific business than the others. Or because of his personal interview, can give more weight to the human factor of management skill, instead of having to rely only on the dry facts of a financial statement submitted by some distant branch. He is more likely to get a loan for a new venture than

he is in Canada, simply because if he tries thirty banking institutions, their loan policies and preferences will vary more widely than those of five national Canadian banks.

New small business ventures are notoriously difficult to finance in Canada. Obtaining adequate bank accommodation to keep pace with the needs of a rapidly growing small Company in Canada is also difficult. The business may have reached the limits of its bank collateral yet be too small or too new to have a stock or bond issue. In frustration, it is sold out to a foreign Company which has the money needed to build the business. Often though, the foreign Company does'nt need to use much of its own cash. They merely arrange with a Canadian bank, under the foreign parent Company guarantee, to provide the business with the amount of money needed, but which the Canadian owner could'nt get. The business thrives and grows rapidly into a major Company. We then cry out against its foreign ownership. Instead we should cry out against our monolithic banking system in favour of a system with many smaller institutions competing on equal grounds, instead of eight banks which control all of banking in Canada.

(5) CONCLUSIONS

(a) A positive step to fight inflation in Canada should be taken by the immediate reduction of the rate of interest paid by banks and loan and trust corporations on savings deposits to 4%. If they won't act voluntarily, the Bank of Canada or the Government should intervene.

(b) To lower the cost of mortgage and commercial loans, the Government should act immediately to implement the balancing recommendations of the Porter Commission by amending the Bank Act to bring savings banks and loan and trust corporations under the Bank Act as banks.

(c) Alternatively, the federal Loan and Trust legislation or the individual provinces' Loan and Trust legislation should be amended immediately to extend the powers of loan and trust corporations to permit them to make commercial and personal loans.